

Service Date: December 29, 1994

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * * * *

IN THE MATTER OF the PSC's Investigation)	UTILITY DIVISION
of the Regulatory Status of Other Common)	DOCKET NO. 94.2.8
Carriers and Contemplated Rulemaking.)	ORDER NO. 5778d

FINAL ORDER ON PHASE II ISSUES

I. Background And Purpose of Phase II

1. This (OCC) Docket is a natural outgrowth of the Montana Public Service Commission's (Commission) three-year experiment established in the first OCC Docket (No. 88.11.49). In Docket No. 88.11.49, Order No. 5548a, the Commission changed its regulation of public utilities providing interLATA service. The Commission agreed to revisit those changes, but only after a three-year experiment allowed for the filing of relevant data by the local- and inter-exchange carriers (LECs and IXC).

2. Based on testimony and its own interest in carefully achieving the Montana Telecommunication's Act's (MTA) goal to encourage competition, the Commission opted to experiment with its regulatory policies out of the first OCC Docket. The experiment relaxed several policies and equally applied the remaining policies to AT&T and the OCCs, the regulated IXCs in the Montana interLATA market (the MIIM).

3. While not radical these policy changes sensibly deviated from traditional methods of regulation. First, the tradition of basing AT&T's rates on accounting, revenue requirement costs was relaxed. In turn, rate of return regulation was not imposed on the

OCCs. This policy change reduced the administrative costs for the affected utilities, intervenors and the Commission.

4. Second, since AT&T has not produced an incremental cost of service study since divestiture, the Commission also extended this policy of relaxed regulation to the OCCs; prices, however, are required to exceed incremental costs.

5. Third, the Commission retained the maximum allowable rate and carrier access charge (MAR and CAC) flow through pricing policies that AT&T initially proposed in Docket No. 86.12.67. The Commission also applied these policies to the OCCs out of the first OCC Docket.

6. Fourth, the OCCs and AT&T were equally required to file tariffs and price lists with the Commission. This requirement had numerous aspects including the notice requirement for price changes, and the separation of the price and rate sections of the tariffs.

7. Finally, and to set the stage to review the experiment's success, the Commission initiated a proceeding to collect relevant market data. Docket No. 92.11.66 was established for the sole purpose of developing data reporting requirements. The LECs, the OCCs and several Commission staff members met to discuss relevant data. The final reporting requirements included minutes of use, presubscription and price change data (see Docket No. 92.11.66, Order No. 5664b, page 4 and 5). The experiment concluded in 1994 after the relevant data had been collected.

8. On March 9, 1994, the Commission initiated this Docket to investigate the regulatory status of OCCs. Issues in this Docket were bifurcated (Phase I and II) much as the final order in the predecessor OCC Docket No. 88.11.49 was structured. The purpose of Phase I was to identify firms that ought to be regulated. On May 25, 1994, the Commission issued a "Phase I Final Order" (Order No. 5778b). If Phase I requires additional findings, they will be contained in another order.

9. The purpose of Phase II is to establish policies on the best level of equal regulation for AT&T and the OCCs, the regulated IXC. The best level of equal regulation depends, in part, on the results of the experiment. The March 9, 1994, Notice of Investigation and Contemplated Rulemaking, and Intervention Deadline listed issues that this phase of the Docket would not address. In this Docket, the Commission will not address whether a different level of regulation ought to apply to the regulated IXC (the MTA reinterpretation issue); neither will the Commission address 1+ intraLATA equal access.

10. On April 19, 1994, a Notice of Commission Action raised two additional issues. One issue asked for testimony on the merit, and impact, of allowing USWC to enter the MIIM. A second issue asked for testimony on how customer information fosters competition. This second issue asked how customers, especially residential, are made aware of IXC options and how information to those customers can be improved.

II. The Montana Legislature's Goal

11. In the wake of divestiture, the Montana legislature enacted the MTA. The legislature's overarching goal, as reflected in the MTA, was to increase competition in all Montana telecommunications markets. This goal was not to be achieved, however, by sacrificing universal service.

12. In order to increase competition, the MTA (' 69-3-801 through ' 69-3-824, MCA) established criteria for the Commission to use in regulating each telecommunications market. Those criteria, such as the number and size of competitors, the ability of competitors to provide functionally equivalent substitutes etc., shaped the Commission's decisions in the first OCC docket (Order No 5548a, Findings of Fact 69 through 109). The Commission is equally cognizant of these criteria in this Docket.

III. The Montana InterLATA Market

13. Upon divestiture two physically separate telecommunications markets emerged in Montana. Divestiture divided the state into two LATAs (Local Access and

Transport Areas). AT&T was obligated to carry traffic over the LATA boundary, in what is called the interLATA market. In contrast, USWC was obligated to serve customers within each LATA, the so-called intraLATA market. IXC's such as MCI and AT&T could compete in both markets, whereas USWC was prohibited from entering the interLATA market. This Docket only addresses the regulation of utilities that provide interLATA service.

14. The interLATA market, or MIIM, has a number of economic and physical attributes. These attributes include the number and kinds of competitors, the size of these competitors, the sub-markets or types of services provided within the market and the competitor's pricing conduct within the market. Another attribute is the amount of capacity each competitor has. The parties' testimony provided empirical data for these attributes.

15. The empirical evidence on the structure of the MIIM, and the conduct of competitors in the MIIM, reveals a highly competitive market. First, the number of IXC's has increased from eleven in 1990 to nearly fifty in 1994 (Sprint Brief, p. 2 and AT&T Brief, p. 3). It is obvious from this increase that entry into the market is unconstrained. If interLATA IXC's have no bottleneck facilities (MCI Brief, p. 5), it follows that customers are not constrained to take service from any particular IXC.

16. Second, customers can easily select an IXC for interLATA service. Over 84 percent of all lines now have one-plus equal access (AT&T Brief, p. 4). Given that around 40,000 customers switch IXC's yearly, it is also clear that customers are aware of their choices (MCI Brief, p. 5).

17. Third, not only can customers choose among fifty IXC's, but they can also choose among the myriad of services each IXC offers. MCI asserts that there has been an explosion in the number of available services (Brief, p. 11). Sprint and AT&T alone offer about twenty-five new services today that were not available just three years ago. AT&T added that MCI, Sprint, LDDS and Wiltel can offer competitive services (Brief, p. 4).

18. Fourth, another measure of competition is the pricing behavior of IXC's in the MIIM. IXC pricing conduct reveals an effectively competitive market. Increased competition

caused long distance prices to decline by two thirds in the decade since divestiture (Sprint Brief, p. 3). Between 1988 and 1994 the average carrier access charge expense declined 5.114/minute while rates declined 7.184/minute.

19. Fifth, declining prices encourage increased consumption, other things being equal. Since 1991, the market has grown 31.5 percent (Sprint Brief, p. 3).

20. Last, the grip that AT&T had on the market a decade ago has dissipated. AT&T's 73.5 percent market share in 1991 slipped to 61.2 percent in 1993 (Brief, p. 4). Another indicator of AT&T's diminished role is its 40 percent market share of capacity (AT&T Brief, p. 4); it follows that other competitors must have 60 percent of the physical capacity in the MIIM.

IV. A Summary of the Parties' Proposals

21. Eight parties filed testimony or comments in Phase II of this Docket. This section briefly reviews the testimony.

22. The parties' proposals can be organized around three general issues: 1) the best level of IXC regulation in the interLATA market; 2) USWC's entry into the MIIM, and 3) the quality of customer information. The first of these general issues contains a number of subordinate issues.

The Best Level Of Regulation

23 The parties' testimony on the best level of equal regulation revealed three different positions. AT&T, MCI, Sprint and one TRI witness proposed a form of price deregulation. Despite the Commission's decision to not reinterpret the MTA's equal regulation language, LDDS proposed different levels of regulation depending on an IXC's dominance. Mr. Buckalew for the Montana Consumer Counsel (MCC) and Dr. Shepherd for TRI generally prefer the existing level of equal regulation. The following expands on these proposals.

The Price Deregulation Group

24 While we include AT&T, MCI, Sprint and one TRI witness in the price deregulation group, their proposals subtly differ. On one hand, AT&T, MCI and Sprint would drop MAR and CAC flow through, so-called price deregulation. Sprint eventually disfavored MAR regulation, and would only support CAC flow through if MARs continue.

25 One of TRI's two witnesses would relax MAR and CAC regulation. Although this docket is about the best level of interLATA regulation, Mr. Meldahl's initial testimony would phase out intraLATA MARs (TR 294, 295). Later, and in its Brief, TRI submitted a proposal that, once again, experiments with price deregulation. TRI's proposed experiment would suspend MAR and CAC price regulation in the interLATA market. TRI does not find MAR or CAC flow through price regulation burdensome (TR 314).

26 The price deregulation group also proposed changes to the tariff filing process. AT&T and MCI want authority to raise prices after a seven-day notice and to lower prices after a one-day notice. Whereas Sprint proposed a one-day notice for any price change, it argued a customer notice requirement should only apply to price increases that exceed 10 percent. TRI proposed a seven-day notice for any price change. Sprint also proposed a maximum filing fee of \$30.00 and the option to choose how to inform customers of rate increases, and to combine prices, MARs, terms and conditions into one tariff. MCI and TRI want the Commission to continue taking complaints. AT&T and MCI seek authority to make promotional price changes without a price list filing. Last, TRI urged continued reporting of access minute of use (AMOU) data.

An Unequal Regulation Proposal

27 Most parties who disagreed with the equal regulation interpretation of the MTA chose not to contest the Commission's decision. LDDS, however, ignored that decision and in turn proposed a more rigorous level of regulation for firms with large market shares. That proposal is simply irrelevant in this Docket.

Those Favoring MAR and CAC Price Regulation

28 Witnesses for two parties favor the current level of price regulation. Dr. Shepherd's testimony for TRI on MAR price regulation was unequivocal: MAR and CAC flow through price regulation must continue for at least a few more years (TR 140).

29 The MCC's Mr. Buckalew proposed standards to phase out the regulation imposed on the OCCs and AT&T. This phased deregulation proposal attempts to prevent anticompetitive actions by AT&T. With MCC's standards, deregulation would occur in three phases. Given the existing market shares, Phase I regulation would apply equally to AT&T and the OCCs, and would include MAR and CAC flow through price regulation. With this proposal, prices could change after a 30-day notice, and price floors would be set at long-run marginal cost. If the Commission would otherwise adopt the AT&T proposal, then the MCC advises the Commission to retain MAR and CAC price regulation. As the dominant IXC's market share declines, the level of regulation would also decline with the ultimate deregulation of all IXCs serving the MIIM.

USWC's Entry Into The InterLATA Market

30 A number of parties oppose USWC's entry into the MIIM. AT&T holds that USWC's entry would harm the MIIM. Competition in the basic exchange market is needed before USWC enters the MIIM. MCI cited USWC's anticompetitive EAS (extended area service) practices as evidence of what USWC could do if allowed entry into the MIIM. MCI noted, however, that this Commission's existing EAS rules would limit such anticompetitive behavior. MCI added that USWC has no interest in entering the MIIM. Although USWC has exemptions (EAS and cellular) to operate in the MIIM, Sprint believes it is inconsistent with pro-competitive policies to let Bell operating companies into the MIIM. In arguing that AT&T and USWC are the chief threat to small IXCs, Dr. Shepherd also opposed USWC's entry.

31 Parties that favor USWC's entry do so with conditions. Given the MIIM is not effectively competitive, and given AT&T dominates the market, the Telecommunications Resellers Association (TRA) would establish safeguards before allowing USWC entry. While testifying that rates would probably decline and the market would become more efficient with USWC's entry, the MCC also held that USWC would not find it useful to only be allowed into the MIIM. MCC testified that a separate proceeding would be needed to address numerous conditions of entry. In holding that the MFJ (Modified Final Judgement) impedes competition, USWC initially urged the Commission to effectively preapprove its entry, assuming the prohibition would be lifted. Later, USWC advised the Commission to not pursue USWC's entry into the MIIM.

The Quality of Customer Information

32 Several parties testified on the quality of customer information. First, AT&T's Dr. Mayo testified that adequate information is necessary for effectively competitive markets. If customers are unaware of the IXC providing service, it is impossible to hold the IXC responsible for declines in quality of service and for anticompetitive pricing. Absent adequate customer information the IXC can raise prices to supra-competitive levels or let the quality of service decline without any risk of losing profits. However, Dr. Mayo testified that perfect information is not required in order to have effective competition. He added that there are several firms from whom customers can take service, each of which provides information to consumers in a variety of ways. Given the above, Dr. Mayo concludes that customer information barriers do not exist in Montana (TR 91) and that government action is not needed to improve the information flowing to consumers.

33 Second, MCI's Ms. Bennett testified that customers get more information than they want or need. Since customers are inundated with information on options, no need exists to increase the level of information. MCI testified that regulatory flexibility best serves competitive goals. Third, USWC would leave the responsibility of providing information to the IXCs.

34 Witnesses for two other parties were less optimistic. Mr. Meldahl for TRI testified that customers do not know that forty five of the fifty IXC's exist (TR 298). The MCC testified that customers need to know fifty IXC's exist (TR 151). Dr. Shepherd testified for TRI that posted prices are efficient, especially if only required of the dominant firm (TRI DR PSC-125); he added that customer loyalty and habit forming behavior are entry barriers (TR 123).

V. Commission Decisions

35 The Commission's regulatory policies attempt to achieve the Montana Legislature's overarching goal of encouraging competition subject to the constraint that basic service is universally maintained at affordable rates.

36 The Commission's three-year experiment has been beneficial. Even parties that favor relaxed regulation acknowledged the benefit of the experiment. It is, in part, for this reason that the Commission finds merit in TRI's proposal to engage in another experiment (Brief, pp. 14,15). As TRI states, it will be instructive to see how an experimental suspension of MARs and CAC flow through impacts the market. For the period January 1, 1995, through December 31, 1997, the regulated IXC's will be subject to the levels of regulation as outlined below. The Commission will convene a proceeding at the end of the experiment to evaluate the results. The evaluation will be broad and allow for any and all interested parties to participate.

37 For the duration of the experiment the Commission will relax its regulation of IXCs in the interLATA market. The following summarizes this experiment. First, MAR and CAC flow through price regulation is suspended. Second, price lists will be effective upon seven-days notice, unless challenged. Third, promotions must be offered only as part of a tariff filing. Fourth, tariffs will not contain separate rate and price sections. Prices must be merged with the rest of each regulated carrier's tariff. Fifth, filing fees will not change except to reflect the fact that a separate price section of the existing tariffs will cease to exist. Thus, the only filing fees that will continue are the current \$5.00 per page fee with a cap of \$500 per filing. Sixth, the Commission will continue to exercise jurisdiction over customer complaints. Seventh, GAAP should continue as the method of accounting. Eighth, data reporting requirements will also continue as explained later in this order.

38 For the following reasons, the Commission finds that this experiment will result in the best level of equal regulation for IXCs providing interLATA service. The findings below will first address the main issue: relaxing MAR and CAC flow through price regulation; following that, the subordinate issues will be addressed. Finally, additional issues will be discussed.

Reasons To Suspend MAR and CAC Flow Through

39 The Commission's chief reasons for relaxing MAR and CAC price regulation are consistent with the testimony filed by certain parties in this Docket. The testimony of AT&T, MCI, Sprint and TRI indicates that there is no longer a need for continuing such price regulation. Competition in the interLATA market is robust. In addition, no evidence emerged that continuing such price-cap regulation enhances economic efficiency.

40 The Commission's decision is not unusual. Other state commissions have relaxed regulation even further. Montana is the only state with MAR and CAC flow through price regulation (MCI Brief, p. 6). In the majority of states in which USWC operates, MCI and AT&T operate under relaxed regulation (MCI Brief, p.5). MCI added that Colorado,

Washington and Oregon only require price lists and that Idaho has deregulated the equivalent service.

41 There is little risk to eliminating these regulatory requirements. That the MCC guaranteed CAC flow through, even if the requirement is suspended, calls into question the MCC's proposal to continue MAR and CAC flow through price regulation (TR 203). MCC's guarantee throws into bold relief the lack of any risk associated with dropping the mandate. If in three years these policies are found to have negatively impacted competitors or customers, the policies can be changed or revoked. During the three-year experiment, the Commission will consider revoking its relaxed regulatory policy upon a petition by a non-dominant firm or the MCC, or upon its own motion.

42 Finally, there is no concrete evidence that demand is anything but elastic, except possibly for some small users of Message Telecommunications Service (MTS). Consequently, AT&T and other IXCs would not have any incentive to raise their prices above what would otherwise have been the Commission imposed constraint.

43 The Commission will now explain its decisions on the numerous subordinate issues. First, price list changes should be effective upon seven-days notice, unless challenged. Price decreases are as important as increases and should not be treated differently.

44 Second, promotions must be offered via a tariff filing. To allow less visible promotions could do irreparable harm to the competitive processes the Commission seeks to promote. Efforts by an IXC to attract some other IXC's customers need illumination.

45 Third, since MARs are eliminated, there is no need to continue the practice of separating the prices from the rest of the tariff. This separation is not practiced with other regulated utilities. Prices must be merged with the rest of each regulated carrier's tariff.

46 Fourth, filing fees will not change except to reflect the fact that a separate price section of the existing tariffs will cease to exist. Thus, the current \$5.00 per page fee with a cap of \$500 per filing will continue.

47 Fifth, the Commission will continue to exercise its jurisdiction over customer complaints. Complaints may serve as an indicator of the success of the experiment.

48 Sixth, GAAP should continue as the method of accounting.

49 Seventh, the data reporting requirements established in Docket No. 92.11.66 will continue with some modifications (see Order No. 5664b). The Commission requires that the parties supply interLATA minutes of use (MOU) data at the conclusion of the experiment; that is, the parties are to exclude irrelevant data, e.g., intraLATA, interstate, and private line.

50 The Commission is keenly interested in expanding the existing data reporting requirement on IXC pricing behavior. At the conclusion of the three-year experiment, each regulated IXC must: 1) compare its own Montana interLATA MTS prices to interstate MTS prices; 2) compare its own Montana interLATA MTS prices to the equivalent interLATA MTS prices from the states of Washington, Oregon and Colorado (where price list regulation only exists), and 3) demonstrate how CAC cost reductions impact interLATA rates. These data will afford the Commission, and others, an opportunity to judge the success of having relaxed MAR and CAC flow through price regulation.

51 While suspending certain price regulations and relaxing others, the Commission has chosen not to *deregulate* the entire interLATA market in this order. A number of practical reasons counsel against deregulation at this time. Although the market appears to have become competitive some nagging questions and concerns remain. We will enumerate several reasons for finding that it is premature to deregulate the interLATA market.

52 First, AT&T remains a dominant carrier as evidenced by the 61.2 percent average market share. Evidence reveals that AT&T's market share, in certain market segments, exceeds its average. These data indicate that AT&T remains the dominant IXC in this market (TR 166, 174, 179 and 357). The Commission remains concerned how the current decisions will impact the market's competitiveness. While the level of competition

supports relaxed regulation, AT&T's continued dominance, while declining, counsels against total deregulation.

53 Second, the Commission doubts competition explains all price reductions that have occurred over the past three years. In fact, the MCC's testimony (TR 178) buttressed AT&T's response that daytime MTS prices have only decreased in response to CAC flow through (AT&T DR PSC-66). Thus, the Commission suspends CAC flow through with some reservation. For daytime MTS customers, the only reason prices decreased was, in fact, the policy the Commission is about to suspend: CAC flow through. The pricing conduct of the regulated IXCs, over the next three years, should help to illuminate the market's competitiveness.

54 Third, and in regard to pricing conduct, the regulated IXCs have an economic incentive to raise prices in markets for which demand is insensitive to price changes. AT&T's Dr. Mayo clearly expressed the relevance of this fundamental economics axiom (TR 331-335). That firms practice what economic theory suggests is rational was revealed by AT&T's 1993 Annual Report (Docket No. 92.11.66 Data Reporting Requirement, p. 25). This report alerts shareholders to the fact that AT&T raised prices, in markets for which customer demand is insensitive, by \$500,000,000. This Commission's MAR and CAC flow through price regulation protected Montana customers from making a contribution. The question is whether Montana customers will make a contribution over the next three years.

55 Fourth, and finally, the Commission believes that the MFJ=s method of allocating customers to carriers upon equal access office conversion was, and remains, biased. As documented by USWC, the process allocates a share of the nonresponsive customers to IXCs based on each IXC's share of responsive customers (USWC DR PSC-133). The Commission's concern is that this process is inconsistent with the Commission's decision to effectively regulate all IXCs equally.

USWC Entry Into the InterLATA Market

56 Although the issue of USWC's entry into the MIIM elicited thoughtful testimony, the relevance was greatly diminished when congress failed to enact legislation to reform the industry (S. 1822). Whereas the overwhelming evidence reveals an effectively competitive interLATA market today, that condition could be threatened by USWC's entry into the MIIM. The impact of USWC's entry generated two diametrically opposed predictions. The actual impact need not and will not be debated further in this Docket.

57 Similarly, TRA's proposal to increase the competitiveness of local exchange markets is not at issue in this Docket. The Commission will not use this Docket to institute processes to achieve greater LEC competition.

Quality of Customer Information

58 The Commission lauds any effort to improve the quality of information supplied to customers. What is laudable and what is practical are not the same. Bulletin boards would only partially achieve the goal of informing the customers. It is incumbent upon customers to do their own research on available options.

Summary

59 The above policy decisions further the Commission's efforts at reducing the level of regulation imposed on regulated IXCs serving the interLATA market. While stopping short of total deregulation, these policies provide an acceptable degree of consumer and carrier protection. The Commission hopes that such protection will facilitate the transition to an undeniably competitive market. Chief among the provisions are the prohibition of untariffed promotional pricing and the Commission's ability to ensure adequate service and complaint resolution.

CONCLUSIONS OF LAW

1 The provision of two-way switched voice-grade telecommunications originating and terminating in the State constitutes Aregulated telecommunications services@ subject to the regulatory jurisdiction of the Montana Public Service Commission. ' ' 69-3-101 and

69-3-803, MCA. The Commission has authority to supervise, regulate and control public utilities. ' 69-3-102, MCA.

2 The Commission properly exercises jurisdiction over the provision of Aregulated telecommunications services@ pursuant to Title 69, Chapter 3, MCA.

3 The PSC has provided adequate public notice of all proceedings herein and an opportunity to be heard, to all interested parties in this Docket. Montana Administrative Procedure Act, Title 2, Chapter 4, MCA.

ORDER

NOW, THEREFORE, it is hereby ordered by the Montana Public Service Commission that the regulation of interexchange carriers is modified as discussed above.

DONE AND DATED this 21st day of December, 1994, by a 4 - 1 vote.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

BOB ANDERSON, Chairman

BOB ROWE, Vice Chairman
(Written Dissent Attached)

DAVE FISHER, Commissioner

NANCY MCCAFFREE, Commissioner

DANNY OBERG, Commissioner
(Concurring Opinion Attached)

ATTEST:

Kathlene M. Anderson
Commission Secretary

(SEAL)

NOTE: You may be entitled to judicial review in this matter. Judicial review may be obtained by filing a petition for review within thirty (30) days of the service of this order. Section 2-4-702, MCA.

DISSENT OF COMMISSIONER ROWE
DOCKET NO. 94.2.8
FINAL ORDER NO. 5778d
(PROPRIETARY MATERIAL EXPURGATED)

AT&T to Boost Consumer Rates 3.9% Next Week

NEW YORK-AT&T Corp plans to boost rates next week on long distance consumer services.

The company said the new increase on domestic, direct-dialed long-distance service would increase the average monthly phone bill by about 35 cents a month, or 3.9%. That works out to about \$274 million a year in additional revenue for the company.

. . .

"This is bad news for consumers," said Bradley Stillman, legislative counsel of the Consumer Federation of America in Washington.

"AT&T is very healthy. It sets the ceiling on prices and everybody else is able to achieve incredible profitability just by undercutting those prices."

. . .

AT&T has raised prices twice this year, the first being a 6.3% hike in January that pushed revenues up by \$750 million . . .

An AT&T spokeswoman said . . . the January \$750 million increase was passed back to consumers in the form of discounts from AT&T's True Savings discount program.

-Wall Street Journal (December 6, 1994), p. B6.¹

INTRODUCTION.

Perhaps the greatest ethical challenge this Commission faces is how it makes a complicated decision affecting large public

¹This newspaper report is illustrative of the information testified to by TRI witness Meldahl, infra, note 29.

interests, but which because of its complexity the public may not fully understand or even be aware of. This case presents such a challenge. Millions of dollars of small telephone customers' money are at issue. Both the specific case and the general topic have been of intense concern to the industry. With the sole exception of its representative the Montana Consumer Counsel, the public is unaware its interests are at risk.²

²This opinion relies heavily on material provided in response to data requests directed to the parties by the Commission staff. That material was submitted by the parties under a protective order. Section 69-3-105, MCA, authorizes the Commission to grant such protection to "trade secrets." Section 30-14-402 defines trade secrets as information "which derives independent economic value" from not being generally known. Much of this information is of a kind similar to information which the parties used publicly, and is generally known within the industry. As in several other cases, I requested the Commission issue an order for the affected companies to show cause why that information should not be disclosed. On December 12, the Commission voted to issue an order to show cause.

This dissent was written in response to the Commission's actual decision, before seeing the written Order which attempts to justify that decision. The reasoning in the Order is poor, and is directly contrary to the proprietary information produced in this docket. Where necessary, I have added footnotes commenting specifically on the written Order.

The key decision from which I dissent is the elimination of mandatory flowthrough of carrier access charge reductions to lower rates charged by long distance carriers to their customers.

Mandatory flowthrough has been an innovative and effective feature of Montana regulation. It has now saved Montana long distance customers millions of dollars in their long distance bills. Were it retained, it would continue to produce large savings for customers, as carrier access charges continue to be reduced.³

Part I of this opinion explains that both law and the general public interest require that long distance rates be just and non-discriminatory. This part explains the general effect of access charge reductions, reviews statutory requirements, summarizes the public interest nature of long distance service, and argues that the Commission's decision disregards the public interest.

Part II is the core of the opinion. Part II demonstrates that mandatory flowthrough of carrier access charge reductions constrains price increases, and does so consistently with regulatory support for emerging competition. This part shows that basic intrastate "message toll service" (MTS) is not effectively competitive, that mandatory flowthrough does not constrain the industry's ability to expand the scope of real competition, that eliminating mandatory flowthrough will allow

³Flowthrough of carrier access charge changes was first proposed by AT&T in Docket 86.12.67. At that time, AT&T expected access charges to increase.

price discrimination against small customers, and that it will place at risk the allocation of future access charge reductions.

Part III briefly suggests an alternative outcome of this case. It states several first principles for regulating "transitional" telecommunications industries, and notes two large and several smaller decisions which could appropriately have been made in this case.

I. BOTH LAW AND THE PUBLIC INTEREST REQUIRE THAT LONG DISTANCE RATES BE JUST AND NON-DISCRIMINATORY.

A. Flowthrough of Carrier Access Charge Reductions Restrains Unfair Rates.

The redeeming feature of the Commission's current approach to long distance regulation, first adopted in Docket 88.11.49, is mandatory flowthrough of carrier access charge reductions. This is the feature the Commission now jettisons. Access charges paid by long distance companies (interexchange carriers or IXCs) such as AT&T, MCI or Sprint to local exchange companies (LECs) such as U S West and PTI are the largest part of IXC costs.⁴ When access charges are lowered, IXCs are required to lower their "Maximum Allowable Rates" or MARs. This is known as "mandatory flowthrough." Utilities may raise or lower actual prices, but may not raise prices above their MARs. Mandatory flowthrough of

⁴Carrier access generally has three elements: local transport, local switching, and carrier common line. They are all typically charged on a minutes of use basis. Access charges comprise nearly half of all IXC costs. Mark Sievers, testifying for Sprint in Docket 94.1.6, estimated access was 45 percent of Sprint's costs. Access Subsidies, Long Distance Competition and the Elimination of the InterLATA Restriction (February 23, 1994) p. 6, attachment to pre-filed testimony. Other figures place carrier access charges well above half of average IXC costs.

carrier access charge reductions has saved Montana long distance customers millions of dollars, and will continue to do so as access charges decline. The following chart lists annual access charge reductions ordered by the Commission or now pending. Although listed as annual amounts these amounts are cumulative, and recur every year.

ACCESS CHARGES FLOWED THROUGH AND PENDING

<u>U S West.</u>	Docket 90.12.86 (December 2, 1992)	\$ 899,798
<u>PTI.</u>	Docket 92.7.32 (March 12, 1993)	\$ 500,000
<u>TECOM.</u> ⁵	Docket 92.12.79 (May 3, 1993)	<u>\$ 674,911</u>
TOTAL ANNUAL FLOW THROUGH TO-DATE		\$2,074,709
<u>U S West.</u>	Docket 94.1.6 (October 31, 1994)	\$4,000,000
<u>TECOM.</u>	Docket 94.7.25 (pending case)	\$ 30,944

B. Montana Law Requires That Long Distance Rates be Just and Reasonable.

It is instructive to consider both the general provisions controlling Public Service Commission regulation of utilities and the specific provisions concerning telecommunications. Under Section 69-3-102, Montana Code Annotated, the Commission is charged with the "duty . . . to supervise and regulate public utilities." Section 69-3-102 specifically includes "regulated telecommunications service." These are subsequently defined as

⁵Telephone Exchange Carriers of Montana is an association of 3 small regulated telephone companies and 8 cooperatives. It administers access charges and distributes access charge revenues to its members.

"two-way switched, voice-grade access and transport of communications originating and terminating in this state." Section 69-3-803 (3), MCA. This definition unarguably includes intrastate long distance service.

Section 69-3-201 requires that all public utilities provide adequate service and facilities, and that charges, including those for "regulated telecommunications service . . . shall be reasonable and just, and every unjust and unreasonable charge is prohibited and declared unlawful." This dissent establishes that the Commission's Order is inconsistent with its duty to supervise and regulate, and allows long distance providers to set rates for noncompetitive services which are unjust and unreasonable.

These general duties were reaffirmed, not abandoned, by the Montana Telecommunications Act, which states as its purpose "to maintain universal availability of basic telecommunications service at affordable rates." Section 69-3-802, MCA.⁶ The statement of purpose goes on to declare the state's policy to encourage competition to the extent it is consistent with universal service, and to authorize alternative forms of

⁶The majority makes the false and simplistic claim that the MTA's "overarching goal . . . was to increase competition in all Montana telecommunications markets." (Order, par. 11.) First, this dissent establishes that mandatory flow through is consistent with competition and that the Commission's decisions in this case are actually anti-competitive. Second, the Order reads one sentence as trumping both the other objectives of the MTA and the Commission's general statutory authority. Third, the Commission's actions in other areas demonstrate it does not believe this statement. The Commission is unanimously pursuing "extended area service," which is anti-competitive (but does further other legitimate ends), and is not now pursuing 1+ intraLATA presubscription to long distance, which is strongly pro-competitive. Under the Order's reading of the MTA the former would be prohibited and the latter required.

regulation.⁷ The next section of this opinion will discuss the relationship between long distance service and universal telecommunications service.

⁷In a dissent to the Commission's previous order in this case (Notice and Investigation, March 9, 1994) I argued that so-called "equal regulation" of the dominant carrier and non-dominant carriers was in fact inconsistent with encouraging a competitive long distance market. I argued that rejecting an economic interpretation of the statute in favor of a newly-created "engineering approach" to regulation, coupled with extending that engineering approach to issues other than equal versus unequal regulation, as the Commission now effectively does, would probably result in "the lowering of review for the market-dominant and the other larger carriers down to the level of the clearly non-dominant minor carriers. The customers likely will lose." (Dissent at pp. 12-13.) This is exactly what has now occurred.

Section 69-3-807(2), MCA,⁸ does allow full and partial detariffing. Subsection (3) lists considerations in acting upon applications for detariffing, including, "(d) the overall impact of the proposed terms and conditions on the continued availability of existing services at just and reasonable rates."

Subsection (1) affirms that, "As to telecommunications service that is provided under regulation . . . rates, tariffs, or fares must be just, reasonable, and nondiscriminatory." This dissent establishes that the Commission's decision allows unreasonable charges and that it actually encourages price discrimination.

C. Long Distance Service is Affected With Significant Public Interests, and Remains Closely Related to Universal Service.

This section is included only because in deciding this case the Commission seriously asked "just how important is long distance, anyway?" The previous discussion of statutory requirements should largely answer the question. This section is intended to shed what should be unneeded additional light.

"Universal service" has been a public policy goal since at least the Federal Communications Commission Act of 1934, which called for provision "to all the people of the United States a rapid, efficient . . . communications service with adequate

⁸My previous Dissent argued that the Commission was misinterpreting Section 69-3-807. (E.g., Dissent, pp. 4-6.)

facilities at reasonable charges."⁹ This fundamental purpose is no different than the core purpose of the modern Montana Telecommunications Act, previously cited.

⁹47 U.S.C. Section 151.

Penetration (the percentage of households with phones) is the starting point for discussions of universal service.¹⁰ At 94.6 percent, Montana's penetration has increased over the past 10 years, but is still only in the middle-tier of states. 1990 census data reveals about 15 rural Montana counties with less than 90 percent penetration. In addition, there are 24 Montana townsites with less than 80 percent penetration, and many more with less than 90 percent. All of these are rural, and many are located on American Indian reservations. Rural location, education, income, minority status, and age have all been found related to penetration rates. Toll rates have been linked to lower penetration in rural areas.¹¹

Phone service exists on a geographical continuum. Of services under the Montana Commission's jurisdiction, intrastate long distance, "extended area service" within a LATA, and local service are only relatively more or less important. This is only one of the ways in which the traditional distinction between local and "long lines" service is becoming blurred.

Significantly, the Commission has made expansion of the mid-range "extended area service" one of its two highest telephone priorities, to which it is committing significant resources. In

¹⁰Information from Belinfante, Telephone Subscription in the United States (FCC, March 1994), and from 1990 census data. This section cites several reports which are not included in the record. These are intended only as collateral references. It is very significant that the issue of whether long distance service is affected with a public interest was not noticed in this proceeding, and yet played an important part in the Commission's actual deliberations. The March 9, 1994, Notice of Investigation, pp. 1-4, listed the purposes of the this proceeding and the issues to be considered.

¹¹Florida Public Service Commission, Residential Telephone Demand in Small Company Service Territories (September 1986).

a huge, rural state like Montana it is simply wrong to state that long distance service is always less important than local. Increasingly, government, health care, potential employment¹² and other important entities may only be reached by long distance phone calls. Unless they live in the Helena area, everyone who calls the Public Service Commission directly, for help with a utility problem, is making a long distance call.

Long distance calls of the sort described are much less discretionary than are many local calls. The next section of this dissent will establish that mandatory flowthrough of carrier access charge reductions, which this Commission now abandons, is especially well tailored to protect the low volume customers whose calling includes proportionally more of these non-discretionary calls.

¹²Lack of a phone is a significant barrier to employment, especially entry-level employment. See, Butte Community Union v. Lewis, 745 P.2d 1128, 1131 (Mont. 1987).

As do many states, Montana requires both written and oral notice before termination of utility service.¹³ Overwhelmingly, the oral contact is by phone. A National Consumer Law Center study for the State of Maine concluded that lack of phone service directly contributed to the termination of winter heating.¹⁴

Despite efforts to separate them, the connection between long distance and local service remains strong. A Washington Utilities and Transportation Commission study concluded toll rates were the primary cause of local service termination.¹⁵

¹³For phones, see Section 38.5.3339 ARM. Over my dissent, the Commission has voted to undertake rulemaking to relax these requirements for long distance carriers. For gas and electric service, see Section 38.5.1405(2)(e) which requires "a diligent attempt to contact the person, either in person or by telephone."

¹⁴An Evaluation of Low-Income Utility Protection in Maine: Winter Requests for Disconnect Permission, Volume 1 16-19 (July 1988).

¹⁵M. Hall, Disconnection From the Local Telephone Network:

The primary point of this section is that long distance service is intrinsically important for low-volume long distance consumers. The secondary point is that affordability of long distance will affect availability of local service as well.

An Analysis of the Impact of Price Changes on Telephone Customers in Washington State During January 1 Through January 30, 1984 (December 1984). The Montana customer services rules cited in this section should limit this relationship. My work on individual customer service problems persuades me that the relationship does still exist.

There are several reasons for this connection. First, it may be difficult or impossible to obtain only local service; a digital switch is required, and there is a charge for most blocking options. Second, under certain circumstances, local service may still be terminated for non-payment of long distance.¹⁶ Third, most local operating companies bill for the long distance carriers, increasing the confusion between local and long distance in the customer's mind, and increasing the likelihood that the local carrier will use means ranging from informal pressure to termination in order to obtain payment of the long distance amounts. Fourth, payment difficulties with long distance may affect deposit requirements for local service.¹⁷

¹⁶ARM Section 38.5.3339(3)(c) prohibits termination for failure to pay for service provided by another carrier. However, Section 38.5.3332(1)(b)(iv) allows disconnection for nonpayment of "other carriers' regulated services that cannot be disconnected or discontinued separate from local service." From the undersigned's experience, the problem still occurs, particularly in exchanges which have not been converted to digital switching.

¹⁷ ARM Section 38.5.1103 permits deposits where that

This discussion of underlying principles of universal service demonstrates that long distance phone service continues to be affected with significant public interests. These public interests confirm that the Commission should not wholly abandon its statutory responsibility to at least minimally ensure that rates for basic message toll long distance service are just and reasonable.

D. The Commission's Decision Disregards the Public Interest.

utility's service "or a similar type" of service has been terminated within 12 months. Whether correct or not, deposits have been requested in order to obtain local service based on payment difficulties with long distance carriers.

The hearings in this matter were technical. The Commission did not hold "satellite" hearings at which members of the public could testify. The public's interests were represented by the Montana Consumer Counsel, which strongly opposed the action the Commission now takes.¹⁸ Generally, when the Commission hears from long distance telephone customers, it is with complaints about billing or about rates. Customers complain that intrastate long distance is too expensive, or that it is more costly than interstate long distance.¹⁹ By abandoning mandatory flowthrough

¹⁸Although appearing on behalf of TRI, Dr. William Shephard of the University of Massachusetts, a national authority on industrial organization economics, was clearly focused on larger questions of economic analysis and the public interest. His testimony was virtually disregarded during the Commission's actual deliberations, as was MCC's.

¹⁹Competition has helped encourage innovation and efficiency in the interstate long distance market, and has helped lower costs. However, federally mandated cost shifts from interstate to intrastate service are another important driver of interstate cost reductions. The FCC "separations" process, dividing costs between interstate and intrastate is key. Beginning in 1981, the FCC began forcing down the portion of costs assigned to interstate service, until it is now only 25 percent. This leaves more costs to be borne by intrastate and local customers.

The FCC-mandated end user charge (subscriber line charge) which most customers think is part of their local phone bill actually reduces the cost of interstate long distance. The total value of these charges is about \$4 or \$5 billion nationally each year.

Another cost shift resulted from breaking up the provision of "inside wire" service and "customer premises equipment" (the phone itself) which used to be provided as part of basic local service. (Most customers support this.) In Montana, about 44 percent of these revenues used to be recovered from the provision of long distance service. Now, these revenues are no longer recovered by the phone company to help offset its general costs.

of carrier access charge reductions, the Commission is voluntarily giving up its sole remaining tool to address these legitimate customer concerns. When issues are not highly visible to the general public, narrow interests are more able to chip away at the public good.

II. MANDATORY FLOWTHROUGH OF CARRIER ACCESS CHARGE REDUCTIONS CONSTRAINS PRICE INCREASES CONSISTENTLY WITH SUPPORTING EMERGING COMPETITION.

A. The Basic Intrastate Message Toll Service Market is Not Effectively Competitive.

The decision in this docket is based upon several apparent misunderstandings about the nature of economic competition. These include: 1. A belief that "more than 1 firm" is all that is required for competition. 2. A focus on the "engineering" aspects of physically-equivalent services, based on a misreading of Section 69-3-807, MCA.²⁰ 3. A failure to understand that arguably-competitive services and clearly non-competitive services will routinely coexist. Ironically, the Montana Consumer Counsel is concerned that competition will not increase if the current system is changed. (Brief, p. 2.)²¹

²⁰See my previous Dissent, note 2, where MCC witness Greer in Docket 90.12.86 is quoted as stating market share is the explicit measurement of the first 3 factors in subsection 807(3) and the implicit measure of the last 2. The same point was made by MCC witness Buckalew in the most recent hearing. (Tr. p. 157.) See pp. 4-6 of the earlier Dissent for additional discussion, including the statement by counsel for AT&T in the present matter that subsection 807(3) is a statement of the economic concept of market power.

²¹Paragraph 14 of the Order lists some attributes of the intrastate long distance market. The Order fails to discuss in any detail the information generated as part of this proceeding, which overwhelmingly demonstrates the market is not competitive. That information is developed in this dissent.

In a number of instances, the Order confuses interstate and

intrastate conditions. For reasons discussed in this dissent, interstate conditions are of limited relevance, and in any event are themselves the subject of heated dispute.

Paragraph 15 of the Order notes the increased number of firms. This dissent demonstrates that the vast majority of customers lack any access to more than a few, and that the market is completely dominated by the largest of them. This is especially true for MTS.

Paragraph 16 notes that about 40,000 customers a year change long distance carriers. Assuming none change more than once, this is less than 10 percent of Montana customers. This figure actually confirms that there is no effective competition for the majority of Montana intrastate long distance.

Paragraph 17 notes the "myriad of services" available. First, this dissent explains that mandatory flow through does not constrain competition for customers of these services. Second, proprietary information shows that most customers do not use these services. They use MTS. The point is irrelevant to the issue at hand.

Paragraph 19 states AT&T has a 61.2 percent market share. First, counsel for AT&T conceded no measure of market dominance would consider this figure to be competitive. (See note 20.) Second, as established in this dissent, more relevant measures of market dominance such as percentage of customers presubscribing (which are proprietary at this time) evince a much higher market share for AT&T.

Paragraph 38 states competition is "robust." Proprietary data indicates this is false, especially for MTS.

Paragraph 41 states "there is no concrete evidence that demand is anything but elastic, except possibly for some small users of Message Telecommunications Service." First, application of basic economics to the information contained in this proceeding demonstrates that, especially for MTS, the market is highly inelastic. More importantly, most Montana customers are MTS customers. In this statement the Commission both contradicts the evidence, and shirks its responsibility to the core customers it is charged to protect.

In my opinion, the Order's discussion of the intrastate long distance market is so grossly at odds with the data contained in the record that it is "clearly erroneous . . . in view of the substantial evidence on the whole record." Section 2-4-704(2)(a)(v), MCA.

Effective competition requires robust pressure by a group of firms on one another, forcing them to innovate, hold down costs, and keep prices down close to those costs, in order to remain viable in the particular market.²² An ineffectively competitive market may be characterized by pure monopoly, oligopoly of a small number of colluding firms, or one dominant firm setting the terms for all others. The latter most clearly described the Montana message toll service (MTS) market.²³ Effective competition is determined by certain measurements which focus on the market share of the largest firm, the number of competitors, and the ease of entry into the market. Counsel for AT&T conceded

²²To keep prices close to costs, a firm must limit profits. However, for states where individual company rate of return data is available, earnings have been excessive and the four firm market concentration ratios are over 90 percent. "State Experience in InterLATA Toll Deregulation," Robert Loube and Labros Pilalis, *Journal of Economic Issues*, Vol. XXVIII, No. 2, June, 1994, pp. 415-425, cited in MCC Brief, p.5.

²³The ability of a dominant firm to retain its position is recognized in the concepts of the "first mover" advantage and "brand loyalty." In the case of long distance service the procedure through which customers are assigned to long distance carriers when an exchange becomes "equal access" protects the incumbent's advantage. First, "brand loyalty" reinforces the dominant carrier's advantage. Second, the great majority of carriers theoretically available are still not listed on the ballot for new equal access areas. Third, carriers do not receive an equal share of the half of all customers who do not return their ballots. Rather, customers who do not return their ballots to select a carrier are assigned to carriers in proportion to each carrier's share of ballots returned in the first 60 days of "preconversion" to equal access, rather than an equal percentage.

that he knew of no market concentration indices which would characterize AT&T's current market share as competitive.²⁴

Proprietary information in this docket contains a number of different market share measurements. These include: 1. total billed minutes of use; 2. MTS billed minutes of use; 3. percentage of local customers presubscribed to each long distance carrier. Using any one of these three measurements, intrastate long distance is not effectively competitive; the dominant carrier has many times the market share of its next closest rival.

²⁴See Dissent, pp. 13-15. That section discusses market share measurements. It also summarizes the very real debate over whether even interstate long distance is truly competitive. It is not necessary to take a position in that debate in order to address the clearly noncompetitive intrastate MTS market.

Percentage of customers presubscribing to each carrier is particularly significant because it best reflects the degree of competition for basic MTS customers. Using this measure, the dominant carrier's market share is huge, _____ percent, and is _____ (increasing/decreasing). The market share of the two next carriers is tiny (_____ percent for _____ and percent for _____) and has been _____ (increasing/decreasing) for several years.²⁵ Together, these three carriers have _____ percent of the market.

It is significant that even for the relatively more competitive interstate market, the Federal Communications Commission has decided to retain price cap regulation.²⁶ Mandatory flowthrough of carrier access charge changes is even less intrusive and less complex than are price caps. Where, as in intrastate long distance, strong pressure exists to price discriminate against inelastic use, mandatory flowthrough limits this kind of cross subsidization of competitive services by customers for noncompetitive services.

B. Mandatory Flowthrough is Consistent with Supporting Emerging Competition.

²⁵This information is from U S West's proprietary response to the reporting requirements of Order 5664b and data request PSC-135. AT&T's share of presubscribed lines _____ (grew/declined) from _____ percent in 1991 to _____ percent in 1993. PTI and GTE also provided information on presubscription in their equal access areas. Outside the record (and therefore not proprietary), AT&T's market share in the much more competitive interstate market for discount packages is actually increasing. "AT&T Starts Making Inroads Against MCI," Wall Street Journal (December 14), p. A4.

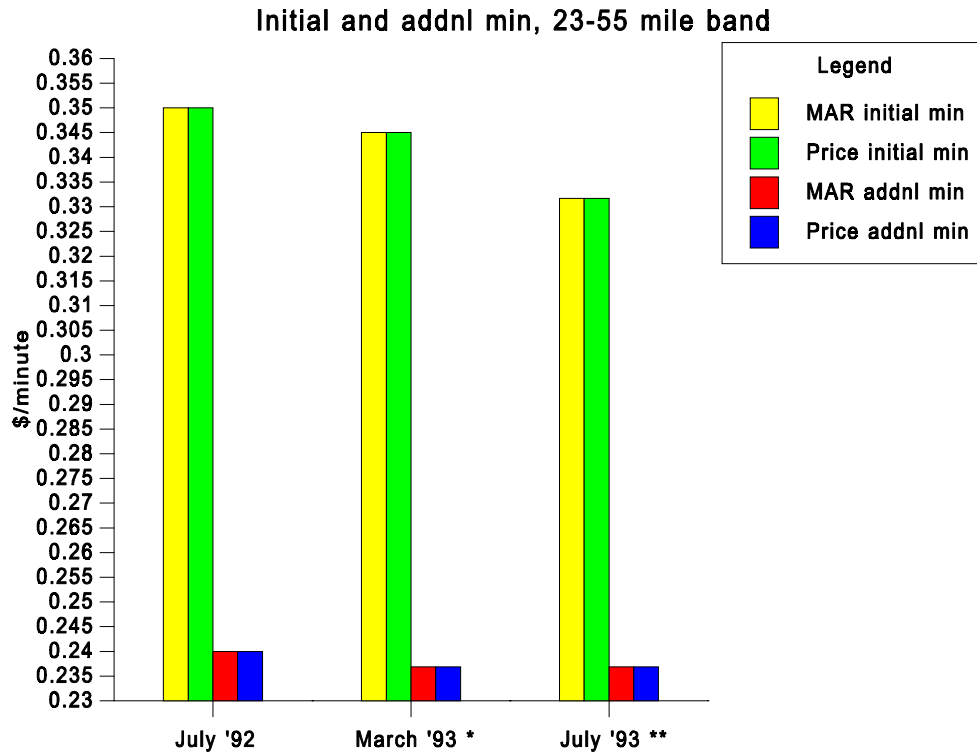
²⁶In the Matter of Price Cap Performance Review for AT&T, CC
Docket No. 92-134 (Report, June 24, 1993).

IXCs have complete freedom to lower prices, so long as those prices remain above costs (ensuring prices are not predatory). IXC's have freedom to introduce any new product they chose, and to do so on very short notice. They may price these products almost any way they choose. Mandatory flowthrough primarily affects message toll service rates and prices.

The only action constrained by mandatory flowthrough of carrier access charge reductions is the ability to raise prices.

Because most of AT&T's prices are already at its MARS, it may not now raise those prices. When flowthrough forces down AT&T's MARS, prices must follow. The following chart shows that every reduction in AT&T's MTS prices since 1991 has been the result of mandatory flowthrough:

AT&T's MARs and Prices



- * Required MAR reduction following Commission-ordered carrier access charge reduction in U S West Docket No. 90.12.86.
- ** Required MAR reduction following Commission-ordered carrier access charge reduction in PTI Docket 92.7.32 and TECOM docket 92.12.79

The effect of mandatory flowthrough is confirmed by AT&T's answer to data request PSC-66, which states that each MTS price reduction since January 1, 1991, was caused by flowthrough of carrier access charge reductions.²⁷

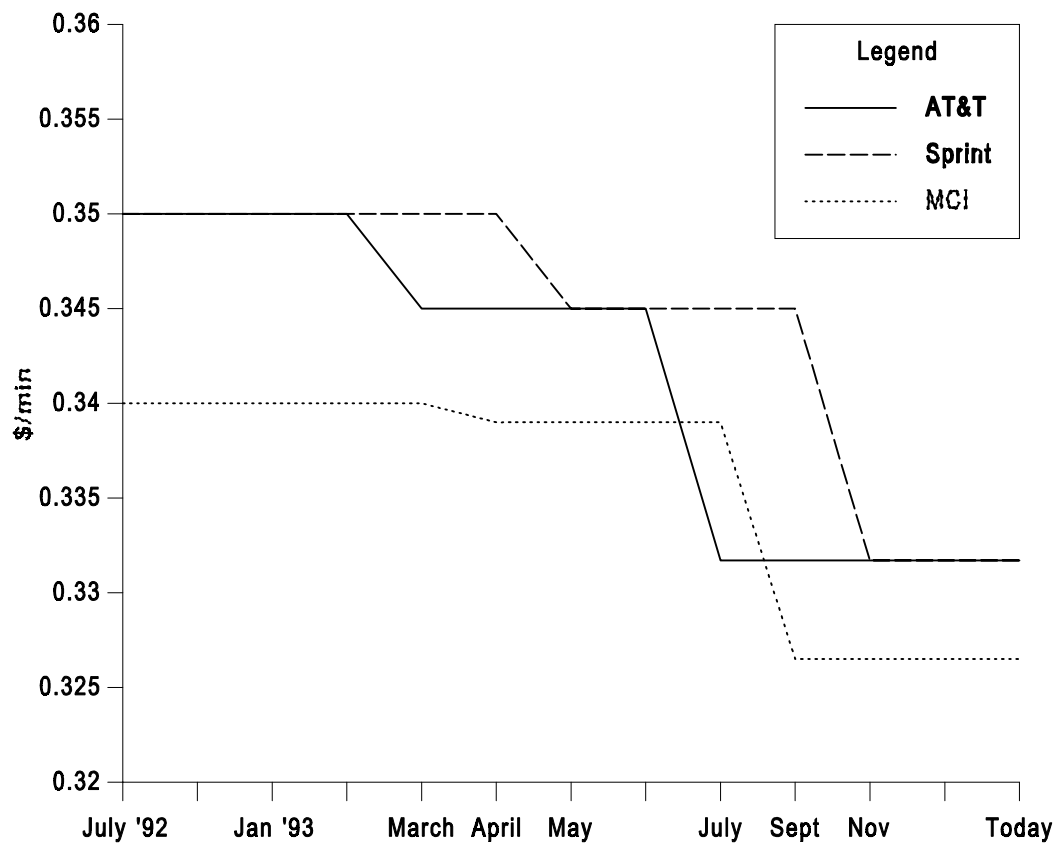
The other IXCs' prices are below their own MARs, but are essentially the same as AT&T's prices.²⁸ Unless AT&T raises its prices, the other carriers will not raise theirs. Sprint witness Phelan (Tr. pp. 221-222) and TRI witness Meldahl (Tr. pp.304-305) testified to AT&T's price leadership. MCC witness Buckalew says AT&T's price is the "umbrella." (Tr. p. 156.) This pattern of "umbrella pricing" is confirmed by comparing prices among carriers over time. The exact timing of the change will vary, but when AT&T changes its prices, so do the small carriers. This is demonstrated by the following chart:

²⁷AT&T's answer states: "The frequent [message toll service] reductions . . . were all caused by changes in the MARs. Reductions in addition to those caused by changes in the MARs were accomplished by offering Discount Plans as competitive responses within the residential customer market (emphasis supplied)."

²⁸Mandatory flowthrough forces the other IXCs to lower their MARs, but - if their prices are below the maximum allowable rate - not necessarily their prices.

MTS Rates

23-55 mile band, initial minute



Because the small carriers' prices are below their MARs, mandatory flowthrough indirectly constrains their prices. When AT&T is forced to lower the umbrella of its MARs and prices, the other carriers lower their prices as well. Conversely, if AT&T is granted freedom to raise its prices, there will be no constraint on the smaller carriers. Therefore, the small carriers support freeing AT&T from the constraint of mandatory flowthrough so that they may raise their prices.

C. Eliminating Mandatory Flowthrough Will Allow Rates to Rise for Basic Use, and Will Allow Price Discrimination Against Customers for This Service.

Price elasticity of demand is the extent to which consumption will increase in response to a price decrease, or decrease in response to a price increase. As AT&T witness Dr. Mayo testified, a rational firm will price discriminate on the basis of price elasticities, charging high prices for products with low price elasticity of demand. (Tr. p. 333.) When allowed, AT&T's conduct is consistent with this advice.²⁹

Proprietary information produced as part of this case demonstrates the extent to which much MTS demand is highly price-inelastic. For AT&T, residential MTS customers are responsible for _____ billed minutes of use (BMOU) a year.³⁰ Commercial MTS

²⁹TRI witness Meldahl testified that in 1993 AT&T raised prices and fees by about \$500 million on an annual basis, primarily for services where customer demand is not very sensitive to price. In December, 1993, AT&T filed with the FCC 1994 price increases of \$750 million and also announced new discounts for high volume callers. (Tr. p. 322, quoting AT&T annual report.) See note 1.

³⁰This information is contained in AT&T's proprietary response to data request PSC-65. The information is for 1993.

customers generate _____ BMOU. All of AT&T's other 27 services generate _____ BMOU. This demonstrates the significance of MTS, especially residential MTS.³¹

³¹This demonstrates the falseness both of the Order's touting the availability of other services (par. 17) and of its minimizing the importance of MTS (par. 41).

_____ percent of AT&T's residential customers account for _____ of its revenues.³² In contrast, the top _____ percent of residential customers generate _____ percent of revenues. Without stating proprietary figures, the top few percent generate well over half of MTS revenue.

A small number of business and residential customers consume a high volume of toll. These are the customers for whom the carriers compete, and who are themselves best able to take advantage of competition to obtain lower charges.

In contrast, the huge majority of residential customers consume extremely small amounts of toll. Average consumption of intrastate interLATA toll is less than \$____ worth per month.³³ The cost of switching carriers is \$5 per time. This is only one of several real "transaction costs" involved in changing. It is virtually impossible to obtain useful information about the relative prices of differing carriers. Most are tiny and do not advertise. Most are not even listed in the phone book.

³²This information is contained in AT&T's proprietary response to data request PSC-69. The information is for 1993.

³³Id.

Through the "Additional Issue" procedure I inquired whether we could devise ways to improve the provision of useful price information and comparisons to customers, especially low-volume and MTS customers, in order to facilitate development of a competitive market.³⁴ Ironically, the concept was roundly rejected by industry witnesses. Extensive discussion of information-related barriers to small purchases of complexly-priced products reinforced that the best approach is to continue mandatory flowthrough, rather than attempt to rely exclusively on

³⁴(Now Justice) Steven Breyer describes the crucial role of information:

For a competitive market to function well, buyers must have sufficient information to evaluate competing products. They must identify the range of buying alternatives and understand the characteristics of the buying choices they confront. At the same time, information is a commodity that society must spend resources to produce. The buyer, looking for alternative suppliers, spends time, effort, and money in his search. The seller spends money on research, labeling, and advertising to make his identity and his product's quality known. In well-functioning markets, one would expect to find as much information available as consumers are willing to pay for in order to lower the cost or to improve the quality of their choices. (Footnotes omitted.)

Regulation and its Reform 26 (1982). Breyer goes on to observe that criticisms of information-based regulation tend to be case-specific:

In sum, there is little quarrel with governmental efforts to help consumers obtain necessary information when the information is in fact needed and the intervention lowers the cost of providing it. Critics of intervention tend in particular cases to quarrel with the claim that regulation will lower the costs of its provision.

Id. at 28.

provision of better information to create an effectively competitive market for MTS.

MCC witness Buckalew reviewed the Helena phone book from the witness stand. Only AT&T, American Sharecom, Econocall, TRI and Touch America are listed in the yellow pages. Sprint is not even listed in the Helena white pages. (Tr. p. 199.) Buckalew also testified from direct experience that it is impossible to call one carrier and obtain price information about its competitors. (Tr. pp. 200-201.)

Advertising is targeted to high volume package customers, not to MTS customers. It rarely provides meaningful price comparisons.

The amounts at issue for individual customers are small, leading some to ask "why worry?" The aggregate amount is enormous, now millions of dollars each year.

This Commission holds lengthy hearings on gas and electric price changes of only several dollars a month. MTS long distance customers deserve no less protection. The Commission's lawful responsibility is to ensure rates which are just and reasonable.

Where competition does not do that, as is the case for MTS service, Commission action is legally required.

If prices are inappropriately above costs, if the supplier is obtaining the equivalent of monopoly rents, economic inefficiency may result.³⁵ In this case, the result is actually

³⁵Breyer distinguishes "economic rent" (a firm which simply controls a source of supply cheaper than the current market price) from true "monopoly profit" (a cheap source which could supply the entire market). "Unlike a monopoly profit, the existence of a rent does not mean that there is 'inefficiency' or 'allocative waste.'" *Id.* at 21. AT&T's fiber and digital network, which is able to serve the entire intrastate MTS market and has a steeply declining or near zero marginal unit cost (a classical economic definition of monopoly), probably looks more

a transfer of wealth from hundreds of thousands of small Montana customers to a handful of companies. The great majority of that wealth will be transferred out of state rather than being spent in Montana. This is obviously inconsistent with economic development goals.

D. Eliminating Mandatory Flowthrough Places At Risk the Allocation of Past and Future Carrier Access Charge Reductions.

With one exception, there is now no assurance that maximum allowable rate reductions previously ordered will be continued.³⁶

like Breyer's "monopoly profit."

³⁶The "Hawthorn Effect" refers to the well-established tendency of the subjects of social science experiments to alter their behavior when they know they are being studied. It is the social science equivalent of the uncertainty principle in physics. One hopes there will be a moderating Hawthorn effect in this case, that IXC's will be on their best behavior during the period of review, in order to justify permanent and complete deregulation. This powerful motivation will invalidate any results the industry or the Commission might claim for the "experiment." I expect MTS customers will take the biggest hit once the experiment concludes.

The annual amount from three previous access charge reductions now at risk is \$2,074,709. There is also now no assurance that future access charge reductions will be passed on to all customers.

In every case concerning local exchange company revenue requirements and rate design there is tremendous pressure for the Commission to lower carrier access charges paid by the IXCs to the local phone company. This results in a greater proportion of the local company's revenue requirement being paid by customers for local service, primarily "POTS" customers (plain old local telephone service). Mandatory flowthrough of access charge reductions ensures a substantial portion of those savings enure to the group of customers who as a result of the access charge reductions are paying larger local phone bills than they otherwise would.

Several weeks ago the Commission approved a stipulation between the Montana Consumer Counsel, U S West, and AT&T which reduced access charges by \$4 million annually. A key part of that stipulation was a specific mandatory flowthrough provision.³⁷ TECOM now has pending a possible \$30,944 access charge reduction. (Docket 94.7.25.)

³⁷Application of U S West Communications for Approval of Tariffs Reducing Revenues, Docket 94.1.6, Order No. 5774b (October 31, 1994). Sprint and MCI were also parties. They did not sign the stipulation, but filed a statement of non-objection. The Commission has now approved tariffs for AT&T, MCI, Sprint and Allnet reducing their MARs. TRI has filed a reduction. The impact of flowthrough on AT&T's prices is now proprietary. However, AT&T received a proportionate share of the overall reduction, and is flowing through the reduction to residential and business MARs. Particularly for residential MTS, this will produce a significant aggregate price reduction.

Going forward, mandatory flowthrough will be particularly effective in constraining and reducing the price of daytime MTS.

Again, this is because AT&T is already priced at its maximum allowable rate.

Most observers expect access charges to continue to be driven down. As a result, the amount at stake for ordinary Montana telephone customers - now and in the future - is enormous.

**III. AN ALTERNATIVE APPROACH WOULD BOTH PROTECT CORE CUSTOMERS
AND FOSTER COMPETITION.**

Many states also rushed to deregulate [long distance], declaring as "competitive" many markets that still had only one major firm. The degree of care in such state-level deregulations was often very low.

Dr. William Shepherd³⁸

The majority has wrongly rationalized its decision as an "experiment." This allows the Commission to pretend that if the experiment "fails," mandatory flowthrough may be restored. First, for obvious political reasons restoration is highly unlikely ever to occur. Second, far from being an experiment this is actually the apotheosis of an agenda to deregulate basic intrastate long distance. Third, an "experiment" should have standards by which it will be evaluated; it should have a goal. I have heard no Commissioner state a measurable goal for this action. The Order certainly did not state one. Fourth and most importantly, the Commission is playing with someone else's money. It is conducting its experiment using the ratepayers' money. With nothing to gain and much to lose, that is wrong. The Commission's action is simply the latest example of the "rush to deregulate" for the industry's benefit, not the customers'.

On several occasions I have suggested principles I consider helpful in guiding telecommunications regulation, particularly of mixed competitive and non-competitive markets. These are:

1. **Universal Service.** Maintain universal and adequate service, including appropriate levels of investment and

³⁸"Reviving Anti-Trust Regulation," The Electricity Journal (June 1994) p.18. The Order (par. 39) cites the sorry performance in other states as justification for its actions. As noted, inflated earnings and high market concentration in other states demonstrate that intrastate long distance is not yet effectively competitive.

modernization, and avoidance of inappropriate levels of disinvestment. The definition of universal service is evolving. (Measuring actual performance against service standards continues to be important.)

2. **Preserve network benefits.** Maximize the gains inherent in the telecommunications network (e.g. efficiency and productivity).
3. **Constrain abuses.** Constrain exploitative actions including pricing and cross-subsidies from monopoly to competitive activities, recognizing the coexistence of monopoly and competitive markets, and the dynamic nature of telecommunications.³⁹

As established in my previous Dissent, asymmetrical regulation is clearly more consistent with these principles.⁴⁰ However, even with allegedly "equal" regulation, there are three constructive things which could come out of this docket, consistent with the above principles.

1. **Retain mandatory flowthrough of carrier access charge reductions.** This is the one available step best-designed to "constrain abuses" and avoid cross-subsidy of more competitive services by non-competitive MTS customers. It is consistent with the other two principles because keeping prices more closely aligned with costs supports network efficiency, and new investment is made primarily to meet demand for the more-

³⁹Rowe, Telephone Restructuring and Property Transfer (June 1994), p. 28.

⁴⁰The Commission has retained a consulting economist, Joe Gillan, to advise on its overall approach to telecommunications, particularly U S West. He has advised the Commission that equal regulation is incompatible with industry trends, and that it should be "quarantined" to interexchange carriers. (Memo, October 10, 1994.)

competitive high-volume services. A number of suggestions were made in the docket to revise flowthrough, such as "resetting" the MARs or flowing through reductions directly to prices. These deserved more consideration.

2. Phased deregulation.

In this docket the Montana Consumer Counsel proposed a model under which regulation of all interexchange carriers would be reduced in specific ways as AT&T's market share fell below certain levels.⁴¹ This approach has the advantage of encouraging competition by specifying the measurements and telling firms how they would be regulated at each level. It has the disadvantage of locking the Commission into a specific method. Attempting to improve the quality of price information provided small customers

⁴¹Phased deregulation was first proposed as an alternative form of regulation by MCC witness Greer in Docket 90.12.86, where regulation would have focused on the dominant incumbent firm. MCC's present approach, necessitated by the Commission's equal regulation decision, is "Greer lite." The original Greer approach had the advantage of imposing even less regulation on non-dominant "price taking" firms, and of focusing scarce Commission resources where they will do the most good, on the dominant firm. See note 2 to my original Dissent.

would strengthen this approach. In any event, MCC's proposal also deserved more consideration.

3. Simplify filing requirements.

The Commission could further consider proposals such as those made by Sprint, to simplify various filing requirements, as by combining the terms and conditions sections of the MARS and price filings. The Commission is pursuing some of these issues.⁴²

⁴²E.g., Order, par. 42-45.

CONCLUSION.

I dissent from the Commission's misguided decision in this case. It is contrary to the Commission's legal obligation to ensure rates which are just and reasonable. It betrays the Commission's duty to protect the interests of core customers for regulated services. The decision willfully ignores both the data in the record and sound economic analysis of that data. It is a gift from the regulators to the regulated, and especially to one company. Taken together with the Commission's decision in the first "other common carriers" case to adopt "equal regulation" the Commission's action is as wrongheaded and harmful as any the Commission has taken in the many years I have observed it.

RESPECTFULLY SUBMITTED this 21st day of December, 1994.

BOB ROWE

CONCURRING OPINION OF COMMISSIONER OBERG

DOCKET No. 94.2.8
FINAL ORDER No. 5778d

ALEX MANDL IS CRAFTING AGGRESSIVE STRATEGY FOR FUTURE OF AT&T

New York-....While colleagues viewed decreases of AT & T's onetime 100% share of the long distance market as inevitable, Mr. Mandl has insisted on winning back customers....Mr. Mandl first outlined his strategy early last year in a Wall Street pitch as CFO and it became the corporate battle plan. They remember his first orders: "The erosion has to stop. Start taking back market share."

"For this company and the long distance industry, it was a very dramatic moment." says Mr. Naacchino.

This week, Mr. Mandl briefed Wall Street analysts on the results so far. For the first time since the antitrust breakup, AT & T is taking back market share from MCI and other rivals.

-Wall Street Journal(Dec 16, 1994.A 1)

Perhaps a cloistered nun or a reclusive hermit exists somewhere who is unaware of competition in the long distance toll market, but I doubt it. The vast majority of consumers who watch TV, read magazines or receive mail are bombarded with advertising touting opportunities to switch carriers, receive discounts and even get paid to change companies. The fact there is competition is unquestionable. The challenge facing the Montana Public Service Commission in this docket was to determine the level of regulation appropriate for this industry. Competition, in and of itself, is the antithesis of regulation. Regulation serves to protect the public from monopoly pricing and service offerings.

Montanans are justifiably wary of deregulation. The Commission's response to the breakup of the Bell system and its monopoly on the long distance market has been measured and incremental in nature. Our approach has been a cautious one with a gradually loosening of regulatory oversight and control.

In this order the Commission moves one step further towards deregulation. Given the record of this docket and the Commission's experience in this matter it is an appropriate one with which I heartily concur. My experience as a Commissioner predates the divestiture and I have participated in all of the transitory steps that have led to the point where the Commission now feels comfortable to allow this minimalist approach to regulation.

However, it is important to realize that this order by no means deregulates the toll carriers. The approach outlined is a more rigid approach to regulation than in many of our neighboring states (Washington, Oregon, Colorado, Idaho, and Nebraska and many others) where the filing of price lists is the only regulatory requirement imposed upon the toll carriers. Unlike our neighbors, the Commission has retained jurisdiction over the companies and has preserved its right to revoke on its own motion or upon petition if there is any evidence that the plan is not working. In addition, this order preserves tariffs that must be complied with rather than price lists and limits promotional offerings that may be anti-competitive.

A substantial portions of a toll carriers costs are the charges they pay to the local telephone company for access to the end user. These expenses represent 55 to 65% of the toll carriers expenses and the customers bills. In the just ended three year program, the Commission mandated that any reductions be flowed through to customers. It was an appropriated safeguard given the state of competition at the time.

In reality, this flow through represented more fiction than fact. Maximum Allowable Rates (MARS) reflect actual rates for only two carriers, AT & T and TRI. The remaining carriers file MARS price guides well above actual rates so any flow through rates in their customer's bills was due to competitive pressures from AT & T rather than any mandated reduction in their MARS.

The minority viewpoint in this case is that in the absence of mandated flow through such reductions would not have occurred and will not occur in the future. I believe that premise is wrong.

While AT & T holds a dominant market position and may be a price leader it is also clear that the competitive pressures from other toll carriers has served to restrain prices. I believe that will continue as all carriers aggressively pursue that 16% of the market who make most of the telephone calls. If such is not the case, the Commission has retained the right to review and change the regulatory scheme to one more appropriate.

I am somewhat amused at allegations that regulation is needed to protect the public interest in the toll market. I think there is ample evidence to indicate that prices have decreased and service options expanded with lessened regulation.

AT& T's MARS were established based on 1986 rates. Since that time AT & T has deployed \$ 55 million dollars in fiber deployment in Montana and under traditional rate based rate of return regulation would be able to raise rates substantially to cover that increased rate base investment. It has not been regulation, but competitive pressures which have prevented AT & T from contemplating such action.

The removal of MARS will undoubtedly result in some rate increases. Such is the nature of the beast in a competitive environment. As new markets are sought after by competitors rates will be adjusted. It is clear to me thought that if AT & T prices any offering too high there is a competitor ready and able to go after that niche. One of my biggest fears has been that AT & T may be willing to lose market share feeling that the loss of customers will be offset by revenues from remaining customer base. Hence, I am heartened by the aggressive competitive strategy reflected in the Wall Street Journal excerpt quoted above.

The policy of the state of Montana as established by the Legislature is to promote competition. This order does that and also serves to protect the public interest by retaining an appropriate level of oversight. The MTA precludes predatory pricing so a carrier like AT& T is not able to unfairly drive a competitor out of business by pricing below cost. The Commission expands on that intent by insisting promotional offerings be made only through tariffs to prevent hidden deals and pricing.

This order takes Montana another step in setting the stage to make Montana a more attractive place for toll competitors to do business which will increase opportunities for Montanan's to choose the service and price most attractive to them. A robust toll market is an integral element of any strategy to make sure Montana is not bypassed by the Information Highway.

I believe the majority opinion in this case is correct and will serve Montana well. It allows the Commission to preserve its limited resources in other area where monopolies do exist and there is a pressing public need for vigilant regulation and oversight. Such is clearly not the case in the toll markets.

DANNY OBERG